Office of Chief Counsel
Internal Revenue Service

memorandum

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HPLevine, ID# 62-09574

date: MAY 20 1999

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Revenue Agent Virginia Sherard

from: District Counsel, Kentucky-Tennessee District, Nashville

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subject: [redacted]
I.R.C. § 465 at-risk provisions

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ISSUE:

1. Whether the "worst-case scenario" test under the personally liable provisions of I.R.C. § 465(b)(2) is the same as for the protected against loss provisions under I.R.C. § 465(b)(4)?

CONCLUSION:

1. The "worst-case scenario" test under the personally liable provisions of I.R.C. § 465(b)(2) is the same as for the protected against loss provisions under

I.R.C. § 465(b)(4) and the taxpayers in this case were personally liable under I.R.C. § 465(b)(4).

FACTS AND DISCUSSION:

By memorandum dated April 9, 1999, we made several conclusions concerning the application of Tennessee law and the I.R.C. § 465 at-risk provisions. In your most recent May 7, 1999 request, you pointed out that there may be a distinction in the "worst-case scenario" test between the "personally liable" requirements of I.R.C. § 465(b)(2), and the protected against loss provisions of I.R.C. § 465(b)(4). You seek further direction on whether the taxpayers were personally liable under I.R.C. § 465(b)(2).

We believe that under the facts of this case which involve an LLC loan with the primary member as the guarantor, the "worst-case scenario" tests are the same for both I.R.C. § 465(b)(2) and (4) purposes. The two principles overlap to some degree which has led to some confusion. However, the I.R.C. § 465(b)(4) protected against loss provisions are ultimately broader than the I.R.C. § 465(b)(2) provisions, which is where they diverge.

The analysis of the Tax Court in Brand v. Commissioner, 81 T.C. 821 (1983) is instructive. In determining whether the taxpayers were "personally liable" under I.R.C. § 465(b)(2), the court looked at the legislative history for guidance on the relationship of a guarantor to that provision. The court's review of the legislative history led it to an analysis of whether the taxpayer was protected against economic loss in determining whether the taxpayer was personally liable, a determination further grounded under I.R.C. § 465(b)(4). Id. at 827-28. The Brand court ultimately found that the taxpayer was not personally liable since as a guarantor, he was entitled to reimbursement. This would have also disqualified him under I.R.C. § 465(b)(4), since he was protected against loss.

The court in Melvin v. Commissioner, 88 T.C. 63 (1987), noted that a taxpayer is personally liable if he has the ultimate liability to repay the debt obligation in the event that the partnership is unable to do so. It is important that the court did not equate "personally liable" with primary liability, only ultimate liability as the obligor of last resort.

The ultimate decision faced by the Sixth Circuit in Emershaw v. Commissioner, 949 F.2d 841 (6th Cir. 1991), was whether under the "worst case scenario", the taxpayer was personally liable, that is, did he face any real risk of liability for additional capital to cover the partnership's obligations. Although the Emershaw court decided the case under I.R.C. § 465(b)(4), the ultimate test used by the Emershaw is equally applicable under I.R.C. § 465(b)(2) in determining whether the taxpayer was personally liable, that is, as the obligor of last result. Consequently, we believe that collectively, the Brand, Melvin and Emershaw analyses of "personally liable" under I.R.C. § 465(b)(2) are the test under the facts contained herein that apply under the protected against loss provisions under I.R.C. § 465(b)(4).

Under certain facts, I.R.C. § 465(b)(4) is broader than I.R.C. § 465(b)(2). For example, the Melvin court found that the taxpayer was personally liable, but protected against loss. In making the determination under I.R.C. § 465(b)(2), the court looked at the relationship between the creditor and the debtors and co-obligors in determining the obligor of last result. In determining whether the taxpayer was protected against loss under I.R.C. § 465(b)(4), the court looked at other relationships to see if the taxpayer was truly the obligor of last resort or whether he was entitled to subrogation, reimbursement or other arrangements which limited liability. The Brand court found that the taxpayer was not personally liable as a guarantor under I.R.C. § 465(b)(2) because of the right of subrogation. The right of subrogation would have also disqualified the taxpayer in that case from being at risk under I.R.C. § 465(b)(4) since he was protected against loss. See also Thornock v. Commissioner, 94 T.C. 439 (1990) (court found on the same set of facts that taxpayer not personally liable and protected against loss); and Peters v. Commissioner, 89 T.C. 423 (1987) (not personally liable because of right of subrogation as guarantors).

We agree that the case law has been confusing because of the courts intermingling of the I.R.C. § 465(b)(2) and (b)(4) principles. We suspect that the intermingling has occurred because the same tests are used for both purposes in appropriate cases. The Sixth Circuit in United States v. Leach, 74 AFTR2d 6555 (6th Cir. 1994), initially discussed in general the I.R.C. § 465(b)(2) and (b)(4) principles. It noted that the lower court found that the taxpayer faced no real risk of financial responsibility in the event of default, a conclusion that could have supported disallowance under either I.R.C. § 465(b)(2) or (b)(4). This was based on their earlier Emershaw analysis and determination that the taxpayer was the obligor of last result. The Leach appellate court likewise concluded that the taxpayer was protected against loss and further that the taxpayer was not

at risk of personal liability, seemingly disallowing the deductions under both I.R.C. § 465(b)(2) and (b)(4). Therefore, we believe that the same "worst-case scenario" test would be applied by the Sixth Circuit in determining the obligor of last resort under either I.R.C. § 465(b)(2) or (b)(4). We further believe that in this case, the tests will be the same under either provision of I.R.C. § 465, and that compliance under one provision will mean that both provisions have been complied with.

Under the Sixth Circuit's "worst-case scenario" test, a determination that a taxpayer would not be personally liable under I.R.C. § 465(b)(2) because of the right of subrogation from the primary obligor would be circular. The taxpayer would be liable on the guarantee because the primary obligor could not pay, which under the "worst-case scenario" would also mean that it could not repay him on the guarantee. The Sixth Circuit has stated that the "worst-case scenario" must be reasonably realistic. Resort by a lender to the sole shareholder (or major shareholder or member) in a small entity upon default by a limited liability entity (such as a corporation or LLC) is not only realistic but likely.

In your May 7, 1999 memorandum, you indicated the determination that limited partner (or member in an LLC situation) guarantees create at-risk amounts even when accompanied by a right of subrogation was a substantial issue in the field. Because of this and the confusing and technical nature of the issue, we are seeking post-review by the National Office of the advice contained herein as well as that contained in the April 9, 1999 memorandum. We expect to hear shortly from them and we suggest that you wait to further hear from this office before you proceed further on this issue.

Please contact the undersigned at (615) 250-5072 if you have any questions. We are keeping our file open until we receive the response from the National Office.

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District Counsel

By: _____
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